DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER: 05-0048
Adjusted Gross Income Tax
Tax Period 1999-2002

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Issues

I. Adjusted Gross Income Tax-Net Operating Loss

Authority: IC § 6-8.1-5-1(b), IC § 6-3-2-2.6.

The taxpayer protested the department's failure to carry forward prior year net operating losses to the fiscal year 1999 return.

II. Adjusted Gross Income Tax-Inclusion of Corporations in Combined Return

Authority: IC § 6-3-2-2(m), IC § 6-5.5-1-18, *Container Corporation of America v. Franchise Tax Board.*, 463 U.S. 159, 103 S.Ct. 293 (1983); *Allied-Signal, Inc. v. Director, Division of Taxation,* 504 U.S. 768, 112 S.Ct. 2251 (1992); *ASARCO, Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307 (1982).

The taxpayer protested the inclusion of two corporations into its combined return. The taxpayer also protested the exclusion of one corporation from its combined return.

III. Adjusted Gross Income Tax-Loss on Sale of Account Receivables

Authority: IC § 6-3-2-2(m).

The taxpayer protested the disallowance of a loss deduction on the sale of account receivables.

IV. Adjusted Gross Income Tax-Calculation Issues

Authority: IC § 6-8.1-3-12.

The taxpayer protested the method of calculation used in several areas and failure to give credit for payments made.

Statement of Facts

The taxpayer is a corporation with several subsidiaries and related corporations in the business of creating, manufacturing, and distributing greeting card products. The Indiana Department of Revenue ("department") audited the corporation for the tax years ending February, 1999 through February, 2002. As a result of the audit, the department assessed additional adjusted gross income tax, interest, and penalty. The taxpayer protested this assessment and a hearing was held. This Letter of Findings results.

I. Adjusted Gross Income Tax-Net Operating Loss

Discussion

During the audit, the department determined that the taxpayer needed to file a combined return with many of its subsidiaries and related corporations. Two of the corporations included in the combined return had unused separate return net operating losses (NOLs) from periods prior to the fiscal year ending February 1999 combined return. The taxpayer requests that those NOLs be carried forward against the fiscal year 1999 combined Indiana return.

All tax assessments are presumed to be accurate and the taxpayer bears the burden of proving that any assessment is incorrect. IC § 6-8.1-5-1(b).

Indiana allows the utilization of NOLs in computing the adjusted gross income tax liability of corporations reporting on a combined basis. IC § 6-3-2-2.6. The taxpayer provided documentation of its NOLs.

Finding

The taxpayer's protest is sustained with regards to the net operating loss carryforward. The file will be returned to the audit division to determine the correct Indiana loss amount (if any) available for carryforward into the applicable tax years. The loss will be calculated in accordance with the applicable statute including the application of the separate return year limitation computations if needed.

II. Adjusted Gross Income Tax-Inclusion of Corporations in Combined Return

Discussion

The taxpayer protests the inclusion of two affiliated corporations (corporations A and B) in the combined return. The taxpayer also protests the exclusion of one corporation (Corporation C) from the combined return for the periods the entity did business in Indiana.

Corporation A makes display cabinets and other fixtures. The taxpayer argued that Corporation A should not be included in the unitary return because they are a separate corporation that sells to taxpayer and its related corporations as well as other parties. Corporation A's manufacturing facility and company management are located in North Carolina. The taxpayer buys some of its cabinets from other corporations and is not totally dependent on Corporation A for its fixtures.

Corporation B sells products that are similar but not identical to taxpayer's main product. Corporation B's product is often used in conjunction with taxpayer's primary product. Corporation B's product is sold mainly to unrelated parties. Corporation B had two manufacturing facilities in Tennessee during the audit period. It had no property in Indiana. Corporation B's sales are shipped into Indiana from Tennessee. Corporation B maintains its own customers' list and computer system.

Corporation C was in business for only one year of the audit period, fiscal year 1999. The taxpayer did not own this corporation like it did the others that the department included in the unitary business corporation. Corporation C was not involved in the creation, manufacturing, and distribution of social expression products like the others in the unitary business. Rather, this corporation allowed customers to manufacture personalized product items in retail establishments.

The taxpayer argued that Corporations A and B should not be included in a unitary return for several reasons. First they argued that the corporations A and B did not have sufficient contact with Indiana to be included in a combined return. Secondly, the taxpayer argued against the inclusion of Corporations A and B because they do not meet the definition of "a unitary business" found at IC § 6-5.5-1-18 as follows:

> "[U]nitary business" means business activities or operations that are of mutual benefit, dependent upon, or contributory to one another, individually or as a group, in transacting the business of a financial institution.

This statute defines "unitary business" for the Financial Institutions Tax purposes, not adjusted gross income tax. The basic concepts, however, apply to the adjusted gross income tax.

The only Indiana statute dealing with the issue of unitary business for adjusted gross income tax purposes is IC § 6-3-2-2(m) as follows:

> In the case of two (2) or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests, the department shall distribute, apportion, or allocate the income derived from sources within the state of Indiana between and among those organizations, trades, or businesses in order to fairly reflect and report the income derived from sources within the state of Indiana by various taxpayers.

Indiana law requires first a determination that the entities are operated as a unitary business. After it has been determined that the entities are unitary, the law requires that the income be reported in such a manner as to "fairly reflect" the Indiana income.

The Supreme Court has considered the issue of a unitary relationship for adjusted gross income tax in several cases and with several analyses. The essential characteristic they require for a unitary business is that the individual entities are functionally integrated in a common business. *Container Corporation of America v. Franchise Tax Board*, 463 U.S. 159, 103 S.Ct. 293 (1983).; *Allied-Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768, 112 S.Ct. 2251 (1992); *ASARCO, Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307 (1982). The Supreme Court found that unitary businesses that were functionally integrated shared many common characteristics. They had common ownership. They had centralized management with a corporate strategy including

the various entities. The individual businesses were operated in such a manner as to further a common purpose.

The taxpayer owned corporations A and B. The taxpayer and its related corporations operated businesses creating, manufacturing, and distributing social expression products. There is clear evidence that they operated as a functional whole to achieve these common goals. Management decisions were made to further the common goal of selling all the varieties of greeting card products. The taxpayer's SEC filings included the names of the taxpayer and Corporations A, B, and C. Several of the corporations used the same related accounts receivable servicing corporation.

Significant percentages of Corporation A's product (display cabinets and fixtures for the marketing of the social expression products) were sold to the taxpayer and related corporations. Corporation C's product was displayed with the taxpayer's and Corporation B's product on Corporation A's display cabinets. Labels on Corporation B's product indicate that Corporation B's trademark is held by the corporation that also holds taxpayer's trademarks.

There were substantial intercompany transfers among the various related entities listed in the subsidiary's Cost of Goods Sold. Each year the taxpayer's consolidated federal 1120 return included transfer pricing adjustments. These adjustments distorted the taxpayer's and its subsidiaries Indiana adjusted gross income. To fairly reflect their Indiana adjusted gross income, the taxpayer and corporations A and B must be combined as a unitary business.

The taxpayer did not provide adequate documentation to sustain its burden of proving that Corporation C was part of the unitary business and should have been included in the combined return.

Finding

The taxpayer's protest is denied. Corporations A and B are to be included in the combined return. Corporation C is not to be included in the combined return.

III. Adjusted Gross Income Tax-Loss on Sale of Account Receivables

Discussion

Much of the taxpayer's product is seasonal. It is considered the optimum marketing strategy to have a full selection of seasonal product available for consumers through the last day of any season or holiday. The taxpayer allows retailers to return all unsold seasonal product at the end of the season. There are also discounts for volume purchases, worn or tattered products, outdated products allowances and others. The taxpayer's liberal return policy and the other types of discounts and credits result in significant discounts to the taxpayer's accounts receivables.

During the last three years of the audit, the taxpayer sold its discounted accounts receivables to another related corporation (service corporation). This corporation was formed for several reasons including the achievement of cost savings through consolidation of its collection operations and to help the taxpayer obtain financing from external lenders. The service corporation is owned 75

percent by the taxpayer and 25 percent by a Canadian subsidiary of the taxpayer. Therefore, it does not meet the 80 percent rule necessary to file a federal consolidated return.

To determine the fair market value of the receivables for the sale, the invoiced amount of the receivables is discounted to reflect the taxpayer's historical rate of returned merchandise. The sale of the accounts receivables to the service corporation is without recourse. Therefore the service corporation has no right to reimbursement from the taxpayer for receivables that are not collected in full. The service corporation has no rights in returned merchandise.

The department disallowed the taxpayer's reporting of losses from the sale of accounts receivable to the service corporation because the sale was not an arms length transaction. The taxpayer protests this disallowance. The taxpayer argues that the service corporation was set up for actual business purposes. Further, it argues that the sale of the taxpayer's accounts receivables to the service corporation was an arms length transaction. The taxpayer states that the Internal Revenue Service (IRS) has reviewed the losses generated by the sales. In that review, the taxpayer asserts that the IRS approved the structure of the corporations and sales and has merely not determined the appropriate value to be assigned to the sold accounts receivables. The taxpayer also asserts that the returned merchandise has a value of "0" because the merchandise is destroyed. At most, according to the taxpayer, the value of the returned goods can be no higher than the minimal cost to produce the merchandise. The taxpayer proposes that the department allow the deductions as taken by the taxpayer. The taxpayer asserts that should the IRS determine that the accounts receivables have a value different than that currently reported, the taxpayer would amend its returns and report the adjusted amount to the department as required by statute.

The taxpayer errs in its statement that the service corporation cannot be part of the taxpayer's unitary business for Indiana adjusted gross income tax purposes because it does not qualify to file a federal consolidated return. Indiana does not have the 80 percent ownership rule to be considered a unitary business. The determination as to whether or not a particular corporation is part of a unitary business must be based on the factors discussed in the previous issue.

The taxpayer owns 75 percent of the service corporation. The service corporation was formed by the taxpayer's management to utilize its accounts receivables to obtain bank financing for its business. This function aids the overall group of corporations in achieving its common goal of creating, manufacturing, and distributing of social expression products. The service corporation provides for economies of scale in that it services the accounts of several of the related corporations.

The taxpayer and its related entities sell their accounts receivables to the service corporation, a related corporation. Each of the corporations selling its accounts receivables recognized business losses from the sales of the receivables. These sales and the resulting claims of business losses distorted the results of the Indiana adjusted gross income of the taxpayer and its related corporations. The service corporation would normally be combined with the other members of the unitary business to fairly reflect Indiana adjusted gross income as required by IC § 6-3-2-2(m). However,

the taxpayer did not provide the department with sufficient documentation to combine the adjusted gross income tax returns. Therefore the department disallowed the losses reported from the sales of the accounts receivables to the service corporation.

Since the service corporation's federal return was not provided for the years of the audit, the department properly made adjustments to disallow losses reported from the sales of accounts receivables to the service corporation.

Finding

The taxpayer's protest to the adjustments to disallow losses reported from sales of the accounts receivables to the service corporation is denied.

IV. Adjusted Gross Income Tax-Calculation Issues

Discussion

The department audited the taxpayer pursuant to authority granted it at IC § 6-8.1-3-12. During the course of that audit the department's auditor made certain tax calculations. The taxpayer protested the calculation of the elimination entries made in the audit work papers, the payroll apportionment and the fiscal year 2002 bonus depreciation adjustment. After receipt of the protest letter, the department contacted the taxpayer to obtain the additional data that the taxpayer wanted the department to consider. The department then adjusted the calculations based upon the data provided by the taxpayer.

The taxpayer also protested that two corporations' income tax payments were not credited on the combined return. However, the companies in question were not included in the Indiana audit report for gross income tax. They were only included in the audit report for the combined adjusted gross income tax. The companies in question had originally filed separate returns which reflected a gross income tax liability, but they had losses for adjusted gross income tax. Therefore, all tax payments were to pay the gross income tax liability of the two companies in question. Since those two corporations were not included in the Indiana audit report for gross income tax, the credits used to satisfy their separate gross income tax liability cannot be used to offset the Indiana combined adjusted gross income tax liability. To do so would, in effect, give the taxpayer credit twice for the same tax payment.

Finding

The taxpayer's protest to the original calculations is sustained to the extent that the calculations were adjusted based upon the additional figures supplied by the taxpayer. The taxpayer's protest to the failure to give credit for gross income tax payments made is denied.